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LOSING FAITH: LIMITED LIABILITY COMPANIES IN ARKANSAS AND THE FIDUCIARY DUTIES OF LOYALTY AND GOOD FAITH

*Frances S. Fendler**

Suppose the following hypothetical: A and B set up a Limited Liability Company (LLC) called ABLLC to construct and operate a water park. They sign an operating agreement. ABLLC is a manager-managed LLC, and B is the manager. A owns a 49% membership interest in the LLC, and B owns a 51% interest. B also owns Blackacre, the land that the parties intend to acquire for the LLC, on which the water park is to be built. Although ABLLC has no written contract to purchase Blackacre, the parties' intentions are undisputed. B, as manager, acting on behalf of ABLLC, even makes a contract with a contractor owned by A to construct the water park on Blackacre. At the same time that these negotiations and transactions between A and B are taking place, B is secretly negotiating to sell Blackacre to a third party for a higher price. And that is what she does, without informing A in advance of her decision to do so. A responds by suing B for damages for breach of fiduciary duty.

The Arkansas Supreme Court confronted substantially this situation in *K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC*,¹ its first decision addressing fiduciary duties in Arkansas LLCs.² The significant difference between the hypothetical and the actual case is that B was not an individual but rather three different LLCs owned and managed by the same individuals, either directly or through their personal LLCs. The Arkansas Supreme Court held that the defendants had done nothing wrong and affirmed a grant of summary judgment by the trial court.³ The court failed to

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1. 373 Ark. 14, ___ S.W.3d ___, 2008 WL 659825 (Mar. 13, 2008).

2. Six years ago, in an unpublished opinion, the Eighth Circuit Court of Appeals addressed an allegation of breach of fiduciary duty in an Arkansas LLC. In that case, unlike this one, the operating agreement specifically addressed and permitted the manager's challenged actions. The court relied on that fact in concluding that there had been no breach. *Ault v. Brady*, 37 F. App'x 222, 2002 WL 1301520 (8th Cir. 2002).

3. *K.C. Props. of N.W. Ark., Inc.*, 373 Ark. at 33, ___ S.W.3d at ___. The court also considered the application of ARK. CODE ANN. § 4-32-304 (LEXIS Repl. 2001), captioned "Liability of Members to Third Parties," and properly held that it does not "shield one member of a limited-liability company from being held liable to another member," but rather

focus on the individual defendants' fundamental conflict of interest. It also failed to address the basic fiduciary duties of loyalty and good faith underlying the case and incorporated into Arkansas's LLC Act⁴—duties that were not circumscribed in the parties' LLC operating agreement.⁵ As a consequence, the court failed to put the burden on the defendants, fiduciaries who had a conflict of interest,⁶ to prove to a finder of fact that their actions were fair and in good faith.⁷ Instead, the court decided that the individual defendants were insulated from liability by doing business through the multiple LLCs. This decision is unfortunate. The court missed an opportunity to analyze the fiduciary duties of loyalty and good faith, the relationship between those fiduciary duties, and the privilege of doing business through LLCs in Arkansas.

Because of their control of ABLLC's manager, I contend that the individual defendants owed fiduciary duties of loyalty and good faith directly to the plaintiff, A. Those fiduciary duties transcended the artificial boundaries of the LLCs through which the defendants chose to own and carry out the water park venture that all of the parties contemplated.

This article begins by relating in more detail the facts of *K.C. Properties*.⁸ Then I explain why the individual defendants, who owned and controlled ABLLC's manager, owed fiduciary duties of loyalty and good faith directly to the plaintiff A, despite the device of intervening LLCs that they

"prohibit[s] suit by a third party against one member of a limited-liability company for another member's actions." *K.C. Props. of N.W. Ark., Inc.*, 373 Ark. at 20–21, ___ S.W.3d at ___ (emphasis in original).

4. See ARK. CODE ANN. § 4-32-402(2) (LEXIS Repl. 2001) and discussion *infra* Part III.

5. The defendants did not allege, and the court's opinion does not indicate, that the Ozark operating agreement restricted PMS's fiduciary duties in any relevant way. Thus, this case does not implicate the issues I addressed in an earlier article, *i.e.*, whether and to what extent fiduciary duties in Arkansas LLCs can be restricted or eliminated by the parties' agreement. Frances S. Fendler, *A License to Lie, Cheat, and Steal? Restriction or Elimination of Fiduciary Duties in Arkansas Limited Liability Companies*, 60 ARK. L. REV. 643, 645–47 (2007) [hereinafter "Fendler"].

6. See discussion *infra* Part II.C.

7. See, *e.g.*, *Wal-Mart Stores, Inc. v. Coughlin*, 369 Ark. 365, 370, 255 S.W.3d 424, 428 (2007):

The burden of proving that the transaction between the director and the corporation is made in good faith and is fair to the corporation lies with the director
 "[I]n the search for inherent fairness and good faith to a corporation and its shareholders, conduct of directors must be subjected to 'rigorous scrutiny when conflicting self-interest is shown.'"

(quoting *Hall v. Staha*, 314 Ark. 71, 79, 858 S.W.2d 672, 676 (1993)); Susan Webber (now U.S. District Judge Susan Webber Wright), *Arkansas Corporate Fiduciary Standards—Interested Directors' Contracts and the Doctrine of Corporate Opportunity*, 5 UALR L.J. 39, 53 (1982) [hereinafter "Webber"].

8. See *infra* Part I.

employed.⁹ Next, I demonstrate that the individual defendants may have breached those fiduciary duties by selling Blackacre to a third party without disclosing their plans to the plaintiff, presenting issues of fact that should have precluded summary judgment against the plaintiff A.¹⁰

I. THE FACTS OF *K.C. PROPERTIES*

The facts of the case are complex, as is common when people make investments through multiple limited liability entities. The *dramatis personae* are as follows:

Tim Graham (“Graham”),

Tim Graham, LLC (“Graham LLC”), owned and managed by Graham,

J.B. Hunt (“Hunt”),

J.B. Hunt, LLC (“Hunt LLC”), owned and managed by Hunt,

Bill W. Schwyhart (“Schwyhart”),

Schwahrt Holding, LLC (“Schwyhart LLC”), owned and managed by Schwyhart,

Ozark Mountain Water Park, LLC (“Ozark”),

K.C. Properties of N.W. Arkansas, Inc. (“K.C. Properties”), 49% member of Ozark, owned by Ken Bailey and Carlos Treat,

Buildings, Inc. (“Buildings”), construction contractor, owned by Ken Bailey and Carlos Treat,

Pinnacle Management Services, LLC (PMS), manager of Ozark. PMS’s managers were Graham, Hunt, and Schwyhart, and its members were Graham LLC, Hunt LLC, and Schwyhart LLC,

Lowell Investment Partners, LLC (LIP), 51% member of Ozark. LIP was managed by PMS, although it had no members, no operating agreement, and no assets,

9. See *infra* Parts II & III.

10. See *infra* Part IV.

Pinnacle Hills Realty, LLC (PHR), owner of the land in question. PHR's managers were Graham, Hunt, and Schwyhart,¹¹ and its members were Graham LLC, Hunt LLC, Schwyhart LLC, and

Parker Northwest Properties, LLC ("Parker"), ultimate purchaser of the land.¹²

At the heart of the case is Ozark, an LLC owned by K.C. Properties and LIP and managed by PMS. The parties formed Ozark to construct and operate "the water park at or near the intersection of Interstate 540 and Highway 264 in Lowell, Arkansas."¹³ The parties intended Ozark to buy about 16.5 acres of a 34-acre tract for \$3 million.¹⁴ The 34-acre tract was owned by PHR, an LLC owned and managed by the same individuals who owned and managed PMS, Ozark's manager, and LIP, Ozark's majority member. Ozark and its constituents entered into an operating agreement, and on that same day, Ozark entered into a contract with Buildings to construct the water park. A little over a month later, without prior warning to K.C. Properties, the defendants caused PHR to sell the entire 34-acre tract to a third party, Parker, for over \$8 million.

K.C. Properties¹⁵ sued all of the LLCs (except PHR, the entity that owned the land) and the individuals who lay behind them for breach of contract and breach of fiduciary duties. The trial court entered summary judgment in favor of the defendants. K.C. Properties appealed. The Arkansas Supreme Court affirmed the trial court's grant of summary judgment against K.C. Properties.¹⁶

On its face, PHR's sale of the entire tract to Parker seems unobjectionable. The parties had no written contract for the sale of the land to Ozark, and a landowner who is dealing *at arms length* is, of course, free to sell his land for the highest price he can get for it. That is essentially the rationale the court set out in affirming the summary judgment in favor of the defen-

11. Appellants' Substituted Brief, Volume I, at Arg 3, K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC, No. 07 00471 (Ark. Nov. 8, 2007).

12. The identities of and relationships among these entities and individuals are described in various places throughout the opinion.

13. *K.C. Props. of N.W. Ark.*, 373 Ark. at 18, ___ S.W.3d at ____.

14. Although the defendants were not bound by any written contract to sell the 16.5 acre plot to Ozark, they admitted that the parties intended this transaction to take place. Appellee's Brief at ARG 4, K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC, No. 07 00471 (Ark. Aug. 1, 2007).

15. The contractor, Buildings, Inc., was also a plaintiff in the case, and an appellant.

16. The court reversed the trial court's grant of summary judgment against Buildings on a breach of contract claim. *K.C. Props. of N.W. Ark.*, 373 Ark. at 33, ___ S.W.3d at ____.

dants.¹⁷ The problem here is that the landowner was *not* dealing at arms length with Ozark.

Three individuals were on both sides of the deal and each of these parties understood that the deal entailed the sale of the 16.5 acres to Ozark. Tim Graham, J.B. Hunt, and Bill Schwyhart owned and controlled, either directly or through their personal LLCs, Ozark's manager PMS. As manager, PMS had the duty to further Ozark's interests as the intended buyer. At the same time, these same individuals owned and controlled PHR, the seller of the land. Therefore, the defendants were on both the buy side and the sell side of the deal. As a result, they had a conflict of interest that implicated the fiduciary duties of loyalty and good faith. They may have breached these duties by acting in secret¹⁸ to sell the land to Parker, a third party. At least, the court should have placed the burden on the defendants to prove that the sale of the land to Parker was fair to Ozark and K.C. Properties as its minority member. If the defendants failed to meet that burden of fairness, K.C. Properties should have been allowed to prove whatever damages it may have suffered as a result of the defendants' breach of fiduciary duty.¹⁹

Individuals should not be allowed to escape the strictures of fiduciary obligation through complicated superstructures of limited liability entities, when to do so defeats the justifiable expectations of their business partners (the term "partner" here being used in its common, rather than its legal, meaning). This is not an argument that the court should have pierced the veil. It *is* an argument that entity status should be ignored for purposes of determining liability for breaches of the fiduciary duties of loyalty and good faith in a closely held business venture—at least where these matters are not specifically addressed in the parties' contract. The point is that when individuals enter into a business venture together (whether directly as individuals or through a limited liability entity like an LLC), each places trust in the

17. *Id.* at 26–27, ___ S.W.3d at ___.

18. Although the court does not state that the defendants concealed from K.C. Properties their negotiations to sell the 34-acre tract to Parker, K.C. Properties alleged in its brief that when the parties entered into the Ozark operating agreement on August 5th, the defendants were already negotiating for the sale of the property to someone else. Appellants' Substituted Brief, Volume I, at Arg 14, *K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC*, No. 07 00471 (Ark. Nov. 8, 2007). The defendants did not deny this allegation in their brief. *See Appellee's Brief* at 14, *K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC*, No. 07 00471 (Ark. Aug. 1, 2007).

19. The plaintiff submitted an affidavit by the President of K.C. Properties stating that there was no other suitable land for the water park for sale in the relevant area. *K.C. Props. of N.W. Ark., Inc.*, 373 Ark. at 29, ___ S.W.3d at ___. The court upheld the trial court's finding that the self-serving affidavit was insufficient to defeat the defendants' motion for summary judgment on a promissory estoppel theory. *Id.* at 31, ___ S.W.3d at ___. This ruling does not preclude the possibility that if they had known that Ozark could not buy the defendants' 16.5 acres, the plaintiff could have invested its capital in a different project altogether. *See Meinhard v. Salmon*, 164 N.E. 545, 547 (N.Y. 1928) (Cardozo, C.J.).

other and puts his interests at the mercy of the other. This relationship of dependency is the bedrock upon which the law of fiduciary duty is built.

It is true that the law permits people to protect their assets by doing business through limited liability entities. But while that device may be sufficient to protect against the claims of outsiders, it should not, in the absence of express agreement, defeat the expectation of loyalty and good faith that, by virtue of his dependency, a business partner is entitled to. Put more simply, a person should be able safely to assume the honesty of his business partner unless he has been told that he should not. Absent fair warning, he should not have to be constantly on guard that the person who invited his trust is going to cheat him.

II. FIDUCIARY DUTIES OF OWNERS AND MANAGERS OF LLCs

A. The Arkansas LLC Act's Provisions on Fiduciary Duties and the Court's Reasoning

The starting point is, of course, the Arkansas LLC Act and what it says about duties owed by managers and members of LLCs:

§ 4-32-402. Liability to company; duties

Unless otherwise provided in an operating agreement:

(1) A member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes gross negligence or willful misconduct; [and]

(2) Every member and manager must account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (½) by number of the disinterested managers or members, or other persons participating in the management of the business or affairs of the limited liability company, from any transaction connected with the conduct or winding up of the limited liability company or any use by the member or manager of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to the person as a result of his or her status as manager or member²⁰

The court relied on subsection (1) of the statute to hold that K.C. Properties could not sue anyone except Ozark's other member, LIP, and Ozark's

20. ARK. CODE ANN. § 4-32-402 (1)-(2) (LEXIS Repl. 2001).

manager, PMS.²¹ The court then observed that neither LIP nor PMS sold the 34 acres to another party, and therefore “neither PMS nor LIP committed any act or failure to act constituting gross negligence or willful misconduct for which they could be held liable under § 4-32-402(1).”²² Similarly, the court held that K.C. Properties could not sue the individual defendants or their personal LLCs for breach of contract because none of them were party to the operating agreement.²³ Respecting the complexity of individual limited liability entities created and the care with which the individual defendants cloaked themselves against personal liability, the court set out in detail how it was done:

It is clear that the individuals and their LLCs were not parties to the operation [sic] agreement. “Pinnacle Management Services, LLC, Manager, by Bill W. Schwyhart, Manager” and “Pinnacle Management Services, LLC, Manager, by Tim Graham, Manager” signed the agreement for Ozark. “Pinnacle Management Services, LLC, Manager, by Bill W. Schwyhart, Manager” and “Pinnacle Management Services, LLC, Manager, by Tim Graham, Manager” signed for member LIP. Ken Bailey, President of KC, signed for member KC. “Bill W. Schwyhart, Manager” and “Tim Graham, Manager” signed for Manager PMS. Therefore, the LLCs were not parties to the operating agreement, and Schwyhart and Graham only signed as agents of PMS.²⁴

The court then, in a confusing passage, swept aside an agency argument²⁵ and stated that the plaintiff had cited no authority for its assertion “that the actions of one corporation can be imputed to another solely by their common membership and management.”²⁶ Thus, the court concluded that “there was no breach of the operating agreement or a breach of fiduciary duties.”²⁷

What is remarkable is that the court pinned its rejection of the breach of fiduciary duty claim solely on subsection (1) of Arkansas Code Annotated section 4-32-402. Subsection (1) of the statute addresses only the fidu-

21. “Because LIP and KC were the only members of Ozark with PMS acting as manager, LIP and PMS were the only entities that KC could bring suit against under section § 4-32-402(1).” *K.C. Props. of N.W. Ark., Inc.*, 373 Ark. at 21, ___ S.W.3d at ___. As discussed below, however, section 4-32-402(1) of the Arkansas Code Annotated does not apply to breaches of the fiduciary duty of loyalty, and therefore does not prohibit suits against members or managers for breach of that duty.

22. *Id.* at 21–22, ___ S.W.3d at ___.

23. *Id.* at 23, ___ S.W.3d at ___.

24. *Id.*, ___ S.W.3d at ___. Evidently, the court meant the individual defendants’ personal LLCs were not parties to the operating agreement.

25. *Id.* at 22–23, ___ S.W.3d at ___.

26. *Id.* at 23, ___ S.W.3d at ___.

27. *Id.* at 24, ___ S.W.3d at ___.

ciary **duty of care**. The issue under the duty of care is whether a fiduciary is liable for mismanagement. According to the drafters of the American Bar Association's Prototype Act on which the Arkansas LLC Act was modeled,²⁸ subsection (1)

sets forth the gross negligence standard of care for those participating in management. This is similar to the standard commonly applied to corporate directors, managing partners, or general partners of limited partnerships. In general, as long as managers avoid *self-interested* and grossly negligent conduct, their actions are protected by the business judgment rule.²⁹

As is evident from the fact that they were on both the buy side and the sell side of the planned transaction in this case, the individual defendants were engaged in self-interested behavior.³⁰ Therefore, it is the other principal fiduciary duty—the **duty of loyalty**—that was at issue. The duty of loyalty is addressed by subsection (2) of Arkansas Code Annotated section 4-32-402, set out above. Again, quoting from the drafters of the Prototype Act, “Subsection [(2)], which is based on UPA § 21, sets forth the duty of loyalty of LLC managers and managing members—that is, *the duty to act without being subject to an obvious conflict of interest . . .*”³¹

B. Piercing the LLC Veil

The tension between the existence of fiduciary obligation and the legislative sanction of entities created for the purpose of avoiding personal liability is nothing new. On the one hand, fiduciary duties are created for the pur-

28. See LONNIE R. BEARD & CAROL R. GOFORTH, ARKANSAS LIMITED LIABILITY COMPANIES CH. 5 (1994). Specifically, the Prototype Act was drafted by the Working Group on the Prototype Limited Liability Company Act, Subcommittee on Limited Liability Companies, Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association. 3 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES app. C at App. C-1 (2007) [hereinafter “RIBSTEIN & KEATINGE”].

29. RIBSTEIN & KEATINGE, *supra* note 28, at C-51 (emphasis added).

30. As owners of PHR, the landowner, the individual defendants had an interest in getting the highest possible price for the land. That interest conflicted with PMS's fiduciary duty to Ozark and K.C. Properties to buy the land at the presumably favorable agreed-upon price. This conflict gave the individual defendants a motive to use their control of PMS to favor themselves at the expense of Ozark and K.C. Properties.

31. RIBSTEIN & KEATINGE, *supra* note 28, at App. C-52 (emphasis added). K.C. Properties asked for damages based on subsection (2), a pro rata portion of the benefit of the land deal that the defendants received over and above the \$3 million Ozark purchase price. Appellants' Substituted Brief, Vol. I, at SoC 2, K.C. Properties of N.W. Arkansas, Inc. v. Lowell Investment Partners, LLC, No. 07-00471 (Ark. Nov. 8, 2007). I express no opinion about the merits of this damage claim.

pose of constraining a person who has power over another's resources from using that control to benefit himself at the expense of the other.³² In the context of an LLC, fiduciary duties are imposed on those who manage and control the business of the LLC—the manager in a manager-managed LLC like Ozark.³³

On the other hand, the legislature authorizes the creation of limited liability entities—corporations, limited liability companies, limited partnerships, limited liability partnerships, and limited liability limited partnerships—specifically so that persons can invest capital in an enterprise secure in the knowledge that only their invested capital is at risk if the enterprise fails. Personal assets not contributed to the enterprise are beyond the reach of the enterprise's creditors. The purpose of authorizing limited liability enterprises is to encourage investment of capital in businesses. People are much more likely to invest if they can control their liability exposure.

Sometimes these two doctrines—fiduciary duties and limited liability—come into conflict, and a court decides that fiduciary duty trumps li-

32. The great Roman satirist Juvenal posed the question: “*quis custodiet ipsos custodes*”—roughly translated, ‘who will guard the guardians?’” *Salvato v. Illinois Dept. of Human Rights*, 155 F.3d 922, 923 (7th Cir. 1998). In our legal system, the answer is the law of fiduciary duty. Whether found in case law or in statutes, the law of fiduciary duty constrains the ability of those in control of property of others from taking unfair advantage of those whose property is at their mercy. *See, e.g., Raines v. Toney*, 228 Ark. 1170, 1178, 313 S.W.2d 802, 808 (1958) (“The law imposes a high standard of conduct upon an officer or director of a corporation, predicated upon the fact that he has voluntarily accepted a position of trust and has assumed control of property of others. Even a higher standard of duty rested upon . . . [t]he vice-president and director [because] he was the manager as well.”) *Id.* (citations omitted).

33. ARK. CODE ANN. § 4-32-402 (LEXIS Repl. 2001). Similarly, fiduciary duties are imposed on members in member-managed LLCs. *Id.* Members in manager-managed LLCs have no duties to the LLC or the other members for acts taken solely in their capacity as members. *Id.* § 4-32-402(3). Cf. *Anderson v. Wilder*, No. E2006-2647-COA-R3-CV, 2007 WL 2700068 (Tenn. Ct. App. Sept. 17, 2007) (controlling members in member-managed LLC violated their statutory duty of good faith by expelling other members and reselling their ownership units to a third party at a high price).

The prefatory language in section 4-32-402 of the Arkansas Code indicates that these standards may be varied by the operating agreement. The extent to which fiduciary duties can be restricted or eliminated, however, remains unsettled. *Fendler, supra* note 5. In addition to variance of the standards, the LLC Act permits the parties to agree that one who breaches is relieved of liability for monetary damages. ARK. CODE ANN. § 4-32-404(1) (LEXIS Repl. 2001). Cf. *Frances Fendler Rosenzweig, Director-Exculpation Clauses Under the Arkansas Business Corporation Act of 1987*, 15 UALR L.J. 337 (1993) (interpreting analogous provision in the Arkansas Business Corporation Act of 1987). Moreover, the statute authorizes the LLC to indemnify members and managers against liability. ARK. CODE ANN. § 4-32-404(2) (LEXIS Repl. 2001).

In this case, the Ozark operating agreement did not modify the statutory standards in any relevant way, and the parties evidently did not make an exculpation or indemnification agreement.

mitted liability. One legal theory familiar to lawyers is “piercing the veil,” a doctrine that extends to both LLCs and corporations.³⁴ Piercing cases are entirely fact-specific, and it is difficult to predict what facts will induce a court to apply the doctrine in a particular case.³⁵

The court in *K.C. Properties* refused to apply the piercing doctrine, dismissing the plaintiff’s argument as one merely asserting that the veil should be pierced because the principals of the defendant LLCs were the same: “[B]ased on our case law, PMS, LIP, and the individual LLCs are separate and distinct legal entities regardless of whether they include the same people.”³⁶ However, the court missed the point. Even if the court correctly refused to pierce the LLC veil in this case, it should have held that the individuals controlling the manager of Ozark, while also controlling PHR, the seller of the land, owed fiduciary duties of loyalty and good faith *directly* to the plaintiff, so that piercing was unnecessary.

C. Analogy to Limited Partnership Law

Cases involving partnerships are relevant to the issue of whether business partners owe fiduciary duties to their co-partners, despite an interposed limited liability entity. For example, in *Meinhard v. Salmon*,³⁷ the seminal case on the scope of fiduciary duties owed by partners to one another,³⁸ the court ignored the fact that the defalcating managing partner took title in the name of a corporation he had formed and controlled.³⁹ What mattered was the fact that he personally owed a fiduciary duty to his partner.⁴⁰

34. *Anderson v. Stewart*, 366 Ark. 203, 234 S.W.3d 295 (2006) (affirming trial court’s decision to pierce the veil of an LLC).

35. The case law is so muddled that it has been called “jurisprudence by metaphor or epithet.” ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON CORPORATIONS* 305 (10th ed. 2007) (quoting PHILIP L. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL LAW* 8 (1983)).

36. *K.C. Properties*, 373 Ark. at 14, 33, ___ S.W.3d ___, ___ (2008). In rejecting *K.C. Properties*’ piercing claim, the court relied on *Mannon v. R.A. Young & Sons Coal Co.*, 207 Ark. 98, 179 S.W.2d 457 (1944). In fact, *Mannon* was inapposite. The court did not decide it as a piercing case, but rather the court disposed of it because the action was brought in the wrong court, was time-barred, and did not allege that the controlling corporation had wrongfully converted any of the controlled corporation’s specific property or assets. *Id.* at 102, 179 S.W.2d at 459–60.

37. 164 N.E. 545 (N.Y. 1928) (Cardozo, C.J.).

38. *Meinhard*’s status as a leading case on the law of fiduciary duty is confirmed by the fact that it “has been cited in more than one thousand reported opinions.” Robert W. Hillman, *Closely-Held Firms and the Common Law of Fiduciary Duty: What Explains the Enduring Qualities of a Punctilio?*, 41 TULSA L. REV. 441, 445 (2006). The Arkansas Supreme Court specifically approved *Meinhard* in *Johnson v. Lion Oil Co.*, 216 Ark. 736, 740, 227 S.W.2d 162, 165 (1950).

39. *Meinhard*, 164 N.E. at 546.

40. *Id.*

Cases involving corporate general partners of limited partnerships are particularly instructive on this point. Limited partnerships, of course, are partnerships that involve two kinds of partners: (1) limited partners, who customarily contribute most of the capital to the business, generally do not participate in the management of the partnership business, and enjoy limited liability,⁴¹ and (2) general partners, who manage the business and are personally liable for partnership obligations to the same extent as general partners in general partnerships.⁴² Sometime around 1970, when tax shelters were legal and popular, limited partnerships with marginally capitalized corporations serving as the general partner began to flourish.⁴³ The theoretical unlimited liability of the general partner was, in practice, limited to the amount of the general partner's capital, which could be marginal.

Professor Robert W. Hamilton, a leading authority on the law of business associations,⁴⁴ notes that from the point of view of limited partners, there are a number of significant and deleterious differences between a corporate general partner and a human general partner. Two of these differences are significant to this discussion about LLCs managed by other LLCs:

A claim of breach of fiduciary duty against a general partner is not worth very much if the general partner itself is a corporation with nominal assets. If there is to be recovery, it must be based on a theory that holds the parties that manage the general partner liable for the general partner's breach of duty

...

41. Traditionally, limited partners were prohibited from taking part in control of the partnership business; the penalty for doing so was the loss of limited liability. 3 ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG & RIBSTEIN ON PARTNERSHIP* § 11.02(b) (2008) [hereinafter *BROMBERG & RIBSTEIN*]. The 1976 Revised Uniform Limited Partnership Act allowed limited partners to have some limited participation in management without losing limited liability. *Id.* § 11.02(c). The Uniform Act was amended in 1985 to loosen the strictures even more, enlarging the list of activities in which a limited partner could safely engage and more importantly, requiring that the plaintiff creditor have a reasonable belief that the defendant was a general partner. *Id.* § 11.02(d). The most recent iteration of the Uniform Act, the Uniform Limited Partnership Act (2001), simply abolishes the control rule and provides that a limited partner is not liable for an obligation of the partnership "even if the limited partner participates in the management and control of the limited partnership." UNIF. LTD. P'SHIP ACT § 303 (2001). Arkansas adopted this most recent version of the Uniform Limited Partnership Act by 2007 Ark. Acts 15.

42. 3 BROMBERG & RIBSTEIN, *supra* note 41, at § 11.01(b).

43. Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 79-80 (1997) [hereinafter "Hamilton"].

44. Minerva House Drysdale Regents Chair, Emeritus, University of Texas Law School. Professor Hamilton's extensive list of publications may be found at http://www.utexas.edu/law/faculty/pubs/hamiltrw_pub.pdf.

[Moreover], there are potential conflicts of fiduciary duty whenever a corporation (as contrasted with an individual) is the general partner of a limited partnership. The general partner obviously owes fiduciary duties to the limited partnership and to the limited partners. Corporate officers and directors also owe fiduciary duties to the shareholders of a corporate partner. These fiduciary duties may conflict.⁴⁵

Functionally, there is little difference between a limited partnership with a corporate general partner on the one hand and an LLC (which, for the sake of clarity, I will call the “primary LLC”) with a manager or managing member that is itself also an LLC on the other.⁴⁶ In both cases, any claim the members of the primary LLC have against the manager is worth little if the manager has only nominal assets. In both cases, the manager has a potential conflict of interest that may give rise to such a claim. In the LLC context, if a situation arises in which the managing LLC will gain if the primary LLC loses, the managing LLC’s selfish interest (or, if it is a manager-managed LLC, that manager’s fiduciary duties to its own members) conflicts with its

45. Hamilton, *supra* note 43, at 87. The other differences that Professor Hamilton notes are:

First, a corporate general partner is subject to the control of somebody else. With an individual as a general partner, there is no doubt as to whose decisions will be evaluated under applicable principles of fiduciary duty. Where a corporate general partner is involved, the decision maker may be a panel of individuals or a single person whose identity may or may not be known to the limited partners and whose financial interest in the limited partnership may be great or may be small.

Second, it is relatively easy to control transfers of managerial authority to third persons when individual general partners are involved. . . . In contrast, a corporate general partner is inherently an economic entity which itself may be purchased or sold. . . . [w]ithout a change in the identity of the general partner itself. . . . From the standpoint of the inactive investors who are the limited partners, the identity of those in control of the general partner is usually more important than the formal identity of the general partner itself.

. . .

Fourth, even if a corporate general partner is reasonably capitalized at the outset, subsequent transactions may bleed off these assets to the owners of the corporation without the consent of the limited partnership and without involving a fraudulent conveyance but greatly increasing the potential risks to the limited partners.

Id. at 86–87. These observations hold true equally when LLCs are managers of other LLCs.

46. This discussion applies equally when any limited liability entity is the manager of an LLC, *e.g.*, a corporation or a limited liability partnership. *See, e.g.*, Victor Peterson & Alison N. Zirn, *Corporate Directors LLCs and Liability: It’s not Settled, but Caution is Advised*, 12 BUS. L. TODAY, Jul.–Aug. 2003 at 57 (applying the limited partnership cases to the problem of corporate managers of LLCs). I focus here on LLC managers (1) because K.C. Properties involved LLC managers and (2) because of the popularity in small businesses or limited business ventures of using the LLC form of enterprise in preference to other forms of limited liability entities. *See, e.g.*, Fendler, *supra* note 5, at 643.

fiduciary duties of loyalty and good faith owed to the primary LLC.⁴⁷ Like corporate directors, the manager of an LLC “cannot lawfully manage the affairs of one of the [LLCs] in the interest of the other.”⁴⁸

Because persons who have conflicts of interest are naturally inclined to benefit themselves, Professor Hamilton concludes that in the limited partnership context, the law of fiduciary duty should extend directly from those who control an entity general partner to the limited partnership and the limited partners.⁴⁹ Case law supports this position, limited partnership cases in which courts have imposed personal liability for breach of fiduciary duty on shareholders, officers, or directors of corporate general partners of a limited partnership. The best known case is a Delaware decision, *In re USACafes, L.P. Litigation*.⁵⁰ That case involved a limited partnership called USACafes, L.P. with a corporate general partner. A third party, Metsa Acquisition Corporation, wanted to buy the limited partnership’s assets. Metsa paid \$72.6 million to the holders of the limited partnership interests. Metsa paid an additional \$15–\$17 million to the corporate general partner and the owners and directors of the corporate general partner. The limited partners sued the directors personally on the theory that the defendants had breached their fiduciary duty by, in effect, taking bribes to refrain from bargaining for a higher price for the limited partnership’s assets.

The defendants argued that while it was clear that the corporate general partner owed fiduciary duties to the limited partners, they, as directors of the corporate general partner, did not. The Delaware court disagreed and held that the directors of the corporate general partner owed some degree of fiduciary duty directly to the limited partners. While the court did not define the limits of the directors’ obligation, it concluded that “it surely entails the duty not to use control over the partnership’s property to advantage the corporate director at the expense of the partnership.”⁵¹

Professor Hamilton, relying on *In re USACafes* and other cases,⁵² concludes as follows:

In appropriate cases, fiduciary duties traditionally associated with the general partner should be applied to shareholders, directors, and officers of the corporate general partner. Both the limited partnership and its limited partners should be able to enforce these duties directly. Unless these duties are extended to shareholders or managers of the corporate general partner there is a significant likelihood of opportunistic or

47. “No one can serve two masters. Either he will hate the one and love the other, or he will be devoted to the one and despise the other.” *Matthew* 6:24 (Revised Standard Version).

48. *Rounds & Porter Lumber Co. v. Burns*, 216 Ark. 288, 290, 225 S.W.2d 1, 3 (1949).

49. Hamilton, *supra* note 43, at 107.

50. 600 A.2d 43 (Del. Ch. 1991).

51. *Id.* at 49.

52. Hamilton, *supra* note 43, at 88–92 & 89 n.61 (citing cases).

wrongful conduct by the shareholders or managers, which may injure limited partners and defeat their reasonable expectations when they invested in the limited partnership. Many courts have reached the proper conclusions in these cases but have not articulated a consistent and general rationale. They should do so in the future relying on the ample authority that now exists that permits every court to apply fiduciary duties directly to the shareholders and managers of the corporate general partner.⁵³

The same rationale supports a rule that, in the absence of an enforceable agreement to the contrary, fiduciary duties owed by the manager of an LLC

53. *Id.* at 107. In *K.C. Properties*, of course, the land did not belong to Ozark. *Id.* *K.C. Properties*, however, had an admitted expectation that the sale would go through—an expectation that the defendants took away. A trier of fact should have been permitted to determine whether *K.C. Properties'* expectation was justifiable and thus whether the defendants breached their fiduciary duties.

A number of other cases support the result reached in *In re USACafes*. See, e.g., *Spitzer v. Shanley Corp.*, 870 F. Supp. 565 (S.D.N.Y. 1994) (individual who was chairman of board of corporate general partner and officer and director of general partner's parent corporation held personally liable to limited partners for breach of the duty of care); *In re Integrated Resources, Inc.*, No. 90-B-10411(CB), 1990 WL 325414 (Bankr. S.D.N.Y. Oct. 22, 1990) (imposing fiduciary obligations on sole shareholder of corporate general partner in limited partnership); *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 173 (Del. 2002) (“[W]here a corporate general partner fails to comply with a contractual standard [of fiduciary duty] that supplants traditional fiduciary duties and the general partner's failure is caused by its directors and controlling stockholder, the directors and controlling stockholder remain liable.”) (quoting lower court opinion, 795 A.2d 1, 34 (Del. Ch. 2001)) (the Delaware legislature overruled *Gotham Partners* on another point, see *Fendler*, *supra* note 5, at 673–75); 2 BROMBERG & RIBSTEIN *supra* note 41, at § 6.07(a) n.38.

One Arkansas case indicates that a person who is a part owner and manager of a corporate general partner of a limited partnership does not in that capacity owe fiduciary duties to the limited partners. *Smith v. Elder*, 312 Ark. 384, 392, 849 S.W.2d 513, 517 (1993). This case, however, should hold little precedential value. The individual in question, *Smith*, was the limited partners' attorney as well as an owner and officer of the corporate general partner, *Shiloh*. The court's observation that *Smith's* failure to disclose certain facts to the limited partner/clients “arose from his relationship to the limited partners as their personal attorney and not from any written obligation imposed by the partnership agreements,” was unnecessary to the decision. The issue dealt with the appropriate statute of limitations, and the three-year statute that the court chose applied regardless of the source of *Smith's* fiduciary duty. Moreover, the court did not explain the basis for the statement and failed to recognize that fiduciary duties, although they may involve written obligations, ultimately arise because of the power the manager has over the property of the investors. Justice Brown, concurring, saw the real point: “By not disclosing all pertinent information regarding his self-dealing as a principal of the general partner and by mismanaging the partnership, all of which benefitted *Shiloh* and *Smith* personally, he breached his fiduciary duty to the limited partners and violated the partnership agreement.” *Id.* at 396, 849 S.W.2d at 519 (Brown, J., concurring) (emphasis added). In any event, *Smith* has never been cited for the proposition that owners and managers of a corporate general partner are insulated from liability for breach of fiduciary duty owed to the limited partners.

to its members should extend to and through the chain of owners of the manager LLC.

III. THE FIDUCIARY DUTIES OF LOYALTY AND GOOD FAITH

The duty of loyalty is preeminent in the constellation of the fiduciary duties recognized by common law.⁵⁴ As it originated in the law of trusts, the duty of loyalty was a pure duty of unselfishness; a fiduciary was prohibited from gaining any personal benefit from his position, even if the gain did not harm the beneficiary.⁵⁵ In modern business organizations, the duty does not extend so far. For example, under current Arkansas partnership law, a partner does not breach his fiduciary duty simply because his action benefits himself.⁵⁶

Despite the fact that the duty of loyalty is not as stringent as it may have been originally in the trust context⁵⁷ and that it may be restricted by the parties' agreement to some extent under modern LLC statutes,⁵⁸ the duty in modern business entities is still a potent one. So it was in *K.C. Properties*, because the operating agreement did *not* restrict the respective LLCs' or the individual defendants' duty of loyalty in any relevant way.⁵⁹ Accordingly, the duty is the one set out in section 4-32-402(2) of the Arkansas Code, which is based on the traditional formulation of the duty under section 21 of the original Uniform Partnership Act.⁶⁰ According to the drafters of the Prototype Act, "[b]ecause of the similarity of this section [the section codified as ARK. CODE ANN. § 4-32-402(2)] with the UPA [§ 21], it is anticipated

54. Ethan J. Leib, *Friends as Fiduciaries*, 86 WASH. U.L. REV. 665, 667 (2009) [hereinafter "Leib"].

55. RESTATEMENT THIRD OF THE LAW OF TRUSTS § 78 cmt. b (2007); Webber, *supra* note 6, at 42.

56. ARK. CODE ANN. § 4-46-404(e) (LEXIS Repl. 2001).

57. *E.g.*, Webber, *supra* note 6, at 42-46.

58. *See* Fendler, *supra* note 5, at 669-70. Although the Arkansas LLC Act permits the parties to agree to a restriction of fiduciary duties, at least if the restriction is specific and reasonable, it should not be interpreted to permit the complete elimination of the duty of loyalty. *See* ARK. CODE ANN. § 4-32-404 (LEXIS Repl. 2001). Indeed, Delaware is the only jurisdiction that permits parties by agreement to completely eliminate the duty of loyalty, and even Delaware prohibits consensual elimination of the duty of good faith. DEL. CODE ANN. tit. 18 § 1101(c) (LEXIS Supp. 2006).

59. *See supra* note 5.

60. Section 21(1) of the original Uniform Partnership Act provided:

Every partner must account to the partnership for any benefit and hold as trustee for it and profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

UNIF. PARTNERSHIP ACT 1914 § 21(1). Arkansas's version of the original UPA was identical. ARK. CODE ANN. § 4-42-404(1) (LEXIS Repl. 2001) (repealed effective Jan. 1, 2005).

that the courts will interpret a section such as this to impose duties similar to those in the general partnership”⁶¹ This means that the fiduciary—the manager in the LLC and, as asserted in this article, those who own and control it—may “pursue self-dealing only after getting an informed waiver from her beneficiary and [must] avoid conflicts of interest, secret profits, and misappropriating benefits that should accrue to the beneficiary or the joint relationship.”⁶²

In addition to the duty of loyalty, the fiduciary owes the duty of good faith.⁶³ It is clear in Arkansas that, as a matter of common law, the duty of good faith is a fiduciary one.⁶⁴ The law holds the fiduciary to a higher standard than the duty of good faith and fair dealing that is implied in every contract.⁶⁵ The contractual duty of good faith “emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”⁶⁶ Indeed, the Restatement (Second) of Contracts makes clear that the contractual duty of good faith cannot be defeated through the device of a separate limited liability entity:

A, an oil dealer, borrows \$100,000 from B, a supplier, and agrees to buy all his requirements of certain oil products from B on stated terms until the debt is repaid. Before the debt is repaid, A makes a new arrangement with C, a competitor of B. Under the new arrangement A’s business is conducted by a corporation formed and owned by A and C and managed by A, and the corporation buys all its oil products from C. The new ar-

61. 3 RIBSTEIN & KEATINGE, *supra* note 28, at App. C-52 (emphasis added).

62. Leib, *supra* note 54, at 10.

63. The Arkansas Supreme Court in *Alexander v. Sims*, 220 Ark. 643, 249 S.W.2d 832 (1952), noted that the rigorous duty of good faith between partners that it applied in that case is recognized by “the Uniform Partnership Act, Act 263 of 1941” *Id.* at 650, 249 S.W.2d at 836 (citing *Zack v. Schulman*, 213 Ark. 122, 210 S.W.2d 124 (1948)).

64. *E.g.*, *Wal-Mart Stores, Inc. v. Coughlin*, 369 Ark. 365, 370, 255 S.W.3d 424, 428 (2007); *Cole v. Laws*, 349 Ark. 177, 185, 76 S.W.3d 878, 883 (2002). Under Arkansas’s Partnership Acts, the duty of good faith is classified as an “obligation” rather than a fiduciary duty. ARK. CODE ANN. § 4-46-404(d) (LEXIS Repl. 2001) (partnerships); ARK. CODE ANN. § 4-47-408(d) (LEXIS Supp. 2007) (limited partnerships). The significance of the distinction is far from clear. In addition, it is unclear how the fiduciary duty of good faith, normally understood as adjunct to the fiduciary duty of loyalty, relates to the duty to refrain from “willful misconduct” in the articulation of the LLC fiduciary duty of care in ARK. CODE ANN. § 4-32-402(1) (LEXIS Repl. 2001). Both “good faith” and “willful misconduct” focus on the actor’s culpable state of mind. This is one of the many instances of inartful drafting in the Arkansas LLC Act.

The Delaware Supreme Court also views the duty of good faith as an obligation distinct from the fiduciary duties of care and loyalty. *See In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 63-67 (Del. 2006).

65. *Country Corner Food & Drug, Inc. v. First State Bank & Trust Co. of Conway*, 332 Ark. 645, 655, 966 S.W.2d 894, 899 (1998) (recognizing “that every contract imposes an obligation to act in good faith”).

66. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

rangement may be found to be a subterfuge or evasion and a breach of contract by A.⁶⁷

The fiduciary duty of good faith, on the other hand, is not necessarily tied to contract. More importantly, the Arkansas Supreme Court's descriptions of the duty indicate that the fiduciary duty of good faith is more rigorous than the contractual duty, "stricter than the morals of the marketplace."⁶⁸ Emphasizing the point, the court has described the duty as "the utmost good faith,"⁶⁹ requiring "perfect fairness,"⁷⁰ "utmost frankness and honesty,"⁷¹ and "utmost . . . integrity."⁷²

One component of the fiduciary duty of good faith is a duty of disclosure. The fiduciary must disclose to the beneficiary material facts that fall within the embrace of the relationship.⁷³ For example, in the recent case of *Wal-Mart Stores, Inc. v. Coughlin*⁷⁴ the court held that as part of his duty of good faith, an employee has "a duty as a fiduciary to disclose material facts . . ."⁷⁵ In *Coughlin*, the employee's failure to disclose to his employer that he had been stealing from the employer could void the self-dealing retirement agreement and release so that the employer could sue the employee for fraud and breach of fiduciary duty. The court quoted with approval language from a Louisiana case, *Soderquist v. Kramer*:⁷⁶ "The duty imposed on a fiduciary embraces the obligation to render a full and fair disclosure to the beneficiary of all facts which materially affect his rights and interest."⁷⁷ This has in fact been the law in Arkansas for over half a century. In *Alexander v. Sims*,⁷⁸ the court held that where, in connection with the execution of an agreement that upon the death of one of the partners, the other would succeed to her interest, the procuring partner breached her fiduciary duty of good faith by con-

67. *Id.*, cmt. d, illus. 1.

68. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.). See *Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc.*, 282 Ark. 268, 270, 668 S.W.2d 16, 17 (1984) (quoting *Meinhard*).

69. *Boswell v. Gillett*, 226 Ark. 935, 944, 295 S.W.2d 758, 763 (1956).

70. *Alexander v. Sims*, 220 Ark. 643, 650, 249 S.W.2d 832, 836 (1952).

71. *Id.* See also *Drummond v. Batson*, 162 Ark. 407, 420, 258 S.W. 616, 620 (1924) ("utmost fairness and honesty").

72. *Alexander*, 220 Ark. at 650, 249 S.W.2d at 836.

73. The duty to disclose was the core principle applied in *Meinhard*, and it has been applied in innumerable other cases. See 2 BROMBERG & RIBSTEIN, *supra* note 41, at § 6.06.

74. 369 Ark. 365, 255 S.W.3d 424 (2007).

75. *Id.* at 373, 255 S.W.3d at 430. See also *Willman v. Riceland Foods, Inc.*, No. 4:07CV00488-WAW, 2007 WL 2990422 (E.D. Ark. Oct. 9, 2007) (joinder was not fraudulent, so remand to state court was appropriate, where plaintiff members of Riceland Foods, Inc., a farmer-owned cooperative, alleged that Riceland failed timely to disclose that its rice was contaminated).

76. 595 So.2d 825 (La. Ct. App. 1992).

77. *Id.* at 830.

78. 220 Ark. 643, 249 S.W.2d 832 (1952).

cealing from her co-partner her knowledge of the latter's impending death.⁷⁹ Among the many authorities the court found persuasive was a passage from Joseph Story, *Commentaries on the Law of Partnership*:

The necessity of entire good faith, and of the absence of fraud on the part of partners towards each other, is inculcated by Cicero in terms of deep import and sound morality. . . . Good faith not only requires, that every partner should not make any false representations to his partners, but also that he should abstain from all concealments, which may be injurious to the partnership business.⁸⁰

The same rule applies in modern partnership law. The current Arkansas Uniform Partnership Act requires that partners disclose without demand "information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement or this [Act]."⁸¹

IV. POTENTIAL BREACH OF FIDUCIARY DUTIES IN *K.C. PROPERTIES*

Putting these principles together—the principle that individuals who own and control a manager LLC owe fiduciary duties to the primary LLC and its members and the principle that those fiduciary duties consist of the duties of loyalty and good faith, including the duty of disclosure—it is apparent that there is a question of fact for the fact-finder here: Did these defendants breach the fiduciary duty they owed the plaintiff? A recent New York decision with facts somewhat analogous to *K.C. Properties* is instructive.

In *Blue Chip Emerald LLC v. Allied Partners, Inc.*,⁸² the court was confronted by a joint venture structured as an LLC called Ceppetto Enterprises LLC (the "Venture"). The Venture was owned 50% by BCE, an acronym the court used to refer to Blue Chip Emerald LLC and its owners, and 50% by a group the court called the Richard and Eric Hadar Defendants, composed of Ceppetto Holdings LLC and its individual principals named Hadar. Ceppetto Holdings LLC was the managing member of the Venture. The Venture's only asset was a building in Manhattan. The BCE plaintiffs sold their

79. *Id.* at 649–51, 249 S.W.2d at 836–37. *Accord*, *Smith v. Citation Mfg. Co. Inc.*, 266 Ark. 591, 587 S.W.2d 39 (1979) (corporate officer and director had duty to disclose the fact that other corporation he owned would not be able to pay for equipment sold to it).

80. *Alexander v. Sims*, 220 Ark. 643, 650, 249 S.W.2d 832, 836 (1952) (quoting JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 172 (4th ed.1855)).

81. ARK. CODE ANN. § 4-46-403(c)(1) (LEXIS Repl. 2001).

82. 299 A.D.2d 278, 750 N.Y.S.2d 291 (2002) (cited with approval by the Arkansas Supreme Court in *Wal-Mart Stores, Inc. v. Coughlin*, 369 Ark. 365, 372, 255 S.W.3d 424, 429 (2007)).

interest in the building to the Hadar defendants for a price based on an \$80 million valuation of the building. Two weeks later, the Hadar defendants sold the building for \$200 million to a third party. When the BCE plaintiffs sued the Hadar defendants for breach of fiduciary duty, the trial court dismissed the case on the ground of a release that the BCE plaintiffs had signed when they sold their interest to the Hadar defendants.

The Appellate Division reversed, saying,

The key fact overlooked by the [lower] court is that the Hadar Defendants, as co-venturers and, in particular, as managing co-venturers (*see Birnbaum v. Birnbaum*, 73 N.Y.2d 461, 465, citing *Meinhard v. Salmon*, 249 N.Y. 458, 468), were fiduciaries of BCE in matters relating to the Venture until the moment the buy-out transaction closed, and therefore owe[d] [BCE] a duty of undivided and undiluted loyalty . . . [I]t is well established that, when a fiduciary, in furtherance of its individual interests, deals with the beneficiary of the duty in a matter relating to the fiduciary relationship, the fiduciary is strictly obligated to make “full disclosure” of all material facts . . .

It follows from the foregoing principles that, in negotiating the Buy-Out Agreement [by which the Hadar defendants bought BCE’s interest], the Hadar Defendants had no right to keep to themselves or misrepresent material facts concerning their efforts to sell or lease the Venture’s Property, such as, for example, the prices prospective purchasers were offering to pay.⁸³

Notice that the New York court did not allow the defendants to escape liability because they were dealing through their personal LLCs. It was clear to the court that the real fiduciaries were the individual defendants. For that reason, the court reinstated the complaint against the defendants.

Similarly, if the facts were as K.C. Properties alleged, the individual defendants here owed a duty of disclosure to K.C. Properties because they were the principals behind and controlled PMS, the manager of Ozark. The individual defendants, as fiduciaries of Ozark, “had no right to keep to themselves . . . material facts”⁸⁴ concerning the property they had agreed to sell to Ozark. If the plaintiff justifiably expected that the defendants would see their transaction through to closing or termination, the defendants’ behavior would be a breach of their fiduciary duties of loyalty and good faith. Assuming that the plaintiff could show compensable damages, the case should have gone to trial.

83. *Id.* at 279–80, 750 N.Y.S.2d at 294.

84. *Id.* at 280, 750 N.Y.S.2d at 294.

V. CONCLUSION

K.C. Properties presents a classic case of parties using limited liability entities to protect their personal assets from the reach of those whom they have injured. Although the law authorizes limited liability as a component of some types of business organizations, that limited liability is itself limited by separate rules of fiduciary obligation. The fiduciary duties of loyalty and good faith are the law's guarantee of honest and fair behavior by those who are in control of other people's property, thereby protecting the vulnerable. As I have argued elsewhere, public policy mandates that the law recognize a core of minimum decencies incumbent on the manager of an LLC.⁸⁵ By extension, the same policy should apply to those who own and control that manager. To allow an individual to reap the benefits of the control he has over others' property while shedding its burdens solely through the fiction of employing limited liability entities gives effect to one legal principle—limited liability—while ignoring the other—fiduciary obligation. In this case, the court should have recognized that the individual defendants owed fiduciary duties of loyalty and good faith to the plaintiff and that *K.C. Properties* was entitled to its day in court.

85. Fendler, *supra* note 5, at 675–86.